UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

*
* *

Prepared by

Lyman S. Hulbert

Attorney
Office of the Solicitor
Washington, D. C.

For the

COOPERATIVE RESEARCH AND SERVICE DIVISION

Summary No. 35 September 1947

TABLE OF CONTENTS

Quo Warranto Proceedings Fail

The Attorney General of the State of Kansas instituted original proceedings in the Supreme Court of Kansas alleging that the Consumers Cooperative Association was exceeding its powers conferred upon it by its articles of incorporation and the statute under which it was incorporated, and that therefore the Association should be dissolved and a receiver appointed therefor (State, ex rel. v. Consumers Cooperative Association, 163 Kan. 300, _____ P.2d _____).

In the petition filed by the Attorney General of Kansas he alleged that the Consumers Cooperative Association engaged in the following "business activities and industrial pursuits", namely:

> "(a) International trade including shipping of petroleum products overseas to the extent that during 1946 approximately 3,000,000 gallons of motor oil were shipped to some 10 different foreign countries;
>
> "(b) Enters into exchange agreements with all major and independent oil companies in connection with the transportation of oil and gasoline;
>
> "(c) Owns huge oil refineries at Coffeyville, Kansas, Phillipsburg, Kansas, Scottsbluff, Nebraska, where it has a total annual production of more than 130 million gallons of refined fuels and can handle approximately 6 million barrels of crude oil per year; this in addition to one-third interest in a large refinery at McPherson, Kansas, which itself has a capacity of 6,000,000 barrels of crude oil per year;
>
> "(d) Owns canning plants, lumber mills, printing plants, paint factories and other industries;
>
> "(e) Buys, owns and holds extensive oil and gas leases and royalties and oil producing properties;
>
> "(f) Drills, operates and produces approximately 450 oil wells with annual oil runs of nearly one and three-fourths million barrels;
>
> "(g) Owns and operates a vast oil pipe line system;
>
> "(h) Auditing management services and insurance agencies as well as many other business and industrial pursuits."

The Attorney General unsuccessfully contended that all of these activities were beyond the powers of the Association.

The opinion in this case is a landmark opinion, because it interprets a number of provisions of the so-called Standard Cooperative Marketing Act which have heretofore received only scant attention from the courts. The Kansas statute and such statutes generally in their titles do not refer to

cooperative associations being organized thereunder for the purpose of engaging in the handling of supplies, machinery and equipment. Likewise, the preamble to the Kansas statute, as is the case generally, did not refer to these items. However, as is usually the case, in the body of the Kansas statute it was provided that:

> "An association may be organized to engage in any activity in connection with the marketing or selling of the agricultural products of its members, or with the harvesting, threshing, milling, preserving, drying, processing, canning, packing, storing, handling, shipping or utilization thereof, or the manufacturing or marketing of the by-products thereof, or in connection with the manufacturing, selling or supplying to its members of machinery, equipment, or supplies; or in the financing of the above-enumerated activities; or in any one or more of the activities specified herein. Nothing in this act shall authorize such association to engage in the banking business." (Underscoring added.)

The Attorney General of Kansas argued that under this statute the Association must primarily be organized for the purpose of engaging in marketing activities. He argued that an association could not be formed for the sole purpose of engaging in purchasing activities. The Consumers Cooperative Association was solely engaged in purchasing activities.

After a comprehensive review of the cooperative statute under which the Association was organized, the Court held that an association could be incorporated thereunder to engage in the performance of only purchasing functions. The Court then went on to hold that any activities engaged in by an association for the direct purpose of enabling it to better function as a purchasing association were within the scope of the statute. In this connection the following quotations from the opinion are apropos:

> "We shall next consider what is included in the phrase 'engage in any activity in connection with the manufacturing, selling or supplying to its members of machinery, equipment or supplies.' The first question is-If an agricultural cooperative association has authority to engage in the activity of furnishing its members with machinery, equipment and supplies, does it have authority to manufacture them? In making an affirmative answer to this question we have considered the language of G. S. 1935, 17-1604, which has been quoted two or three times already in this opinion, where there is conferred upon the cooperative society to engage in an activity 'in connection with manufacturing, selling or supplying to its members of machinery, equipment or supplies.'
>
> * * * * * * *
>
> "The next question is--If the defendant does have power and authority under the act to manufacture equipment, machinery and supplies, does it have power and authority to manufacture refined products of crude oil or in other words, gasoline and lubricating

oil? This is really the question that brought on this lawsuit. If the CCA had not engaged in operating its refineries and kindred activities it is doubtful if the other activities in which the state alleges it was engaged would have brought on as drastic a proceeding as an ouster suit. In other words, there was no particular attack on agricultural cooperatives as long as they confined their activities to the furnishing to their members of a few incidental supplies, such as binding twine or axle grease or perhaps an occasional roll of barbed wire. The court will take judicial notice of the fact that in the present state of the art of farming gasoline or the somewhat broader term 'farm motor fuel' is one of the costliest items in the production of agricultural commodities. The writer has no doubt there are young farm boys who have never experienced the delight of guiding a team of mules along a furrow, but their agricultural operations have been confined to what fun they could get out of driving a tractor. Perhaps to the writer of this opinion, about 30 years removed from his operations as a farm hand, this delight appears more vivid than it did at the time he was going through it. However, there is still a bond between a farm hand and a good team of horses or mules. Cultivating corn with a team and a tongueless cultivator when an eighteen-year-old boy could reach back with his foot and kick the dirt off of an unfortunate stalk of corn was at the same time an art and an applied philosophy. Anyway, gasoline and tractors are here and this court is not going to say that motor fuel oil is not a supply necessary to the carrying on of farming operations within the purview of the terms of G. S. 1935, 17-1604 and related sections. Indeed it is about as well put as can be on page 18 of state's Exhibit 'C' where defendant says:

> 'Producing crude oil, operating pipe lines, and refineries, are also part of the business of farming. It is merely producing synthetic hay and oats for iron horses. It is "off-the-farm-farming" which the farmer, in concert with his neighbors, is carrying on. Frequently, it determines whether he makes or loses money in any given year on his "fenced-in" farm. Production of power farming equipment, then, is logically an extension of the farmers' own farming operations.'

"After disposing of the question of the operation and authority to manufacture crude oil and refined products the next question is--Does CCA have authority to own and operate such oil wells and pipe lines as are necessary to the existence of its refinery operations? The fact that this question has arisen demonstrates the truth of the doctrine that once a step is taken in a certain economic direction the end lies along a path which perhaps was not contemplated at the outset when the step was first taken. It is easy to see what happened when this agricultural cooperative started a refinery. One could not have been in touch with public events in the state and not have been aware of it.

"The defendant calls our attention to the fact that when cooperative associations first organized their refineries for the purpose of manufacturing tractor fuel and their refined products a movement was immediately started to eliminate them from the industry, by control of the crude oil supply. This, of course, is one phase of the old fight that has always ensued when some new movement first gets under way. The experts at weaving hand looms were just as provoked when machinery for weaving began to displace their efforts. The cotton pickers of the south see that the cotton picking machinery invented will displace many hand cotton pickers in that industry. The same cooperative effort which caused the society to buy and take over a refinery caused it to drill wells and lay pipe lines. Once we reject the narrow construction the state asks us to place upon the act due to G. S. 1935, 17-1601, we have no difficulty in reaching the conclusion that the defendant did not exceed its corporate authority in laying the pipe lines and drilling oil wells." (Underscoring added.)

Another important issue that was presented in the case was whether the statute of Kansas under which the Association was incorporated permitted only associations that were also incorporated under that identical statute to become members of the Association. The statute provided that "One association organized hereunder may become a member or stockholder of any other association or associations organized hereunder."

In view of the foregoing provision, the Attorney General of Kansas argued that the only associations that were entitled to be members of Consumers Cooperative Association were those incorporated under the specific statute under which that Association was organized. The Supreme Court of Kansas, in refusing to adopt this construction of the statute, called attention to a number of provisions in the statute which carried contrary implications, and the Court laid special emphasis upon a provision of the statute which is given in the following quotation from the opinion:

"* * * The other provision set out, however, is a clear indication of the intention of the legislature to provide that one cooperative society may own stock in another. G.S. 1935, 17-1617a provides as follows:

> 'Any association may have an interest in or own the preferred or common stock of, or become a member of any cooperative association.'

"It will be noted that the above section uses the words 'any association' not 'any association organized under this act.' That provision was enacted ten years after the enactment of G. S. 1935, 17-1606, in which it was provided that one association organized under article 16, chapter 17, G. S. 1935, could become a member of any other association organized under the act. The only apparent reason for the enactment of G. S. 1935, 17-1617a would be to clearly provide that one agricultural cooperative association could own stock in another cooperative association regardless of whether or not

such association was organized under article 16, chapter 17, G. S. 1935. * * * "

The Consumers Cooperative Association had not registered its common and preferred stock or certificates of indebtedness with the so-called Blue Sky Department of the State of Kansas prior to their sale. This was apparently done in complete good faith and on the assumption that the Association was not required to register these securities with that Department. The Supreme Court held that the Association was required to register its common and preferred stock and certificates of indebtedness with the Corporation Commission of that State before they could be sold in Kansas, and in this connection the Court said in part:

> "As to questions propounded by the corporation commission we hold that the common and preferred stock and certificates of indebtedness of defendant are required to be registered with the corporation commission before they can be sold in this state; the commission has jurisdiction and power and it is its duty to proceed to hear and determine the application of CCA for permission to register these securities; the securities sold in Kansas without being registered should be registered if the commission on final hearing determines that the issue should be registered; this registration, however, is not to prejudice the rights of any buyer of this stock under the provisions of G. S. 1945 Supp. 17-1240; the deferred patronage refund certificates are not required to be registered."

As indicated in the foregoing quotation, the patronage refund certificates, which the court said "are a means of passing on to members the savings made through trading with the society", were not required to be registered.

In a number of States securities issued by cooperative associations are subject to the blue-sky laws of those States. See Legal Phases of Cooperative Associations, page 35.

Cooperative May Buy Grain

A case which well illustrates a basic, fundamental difference between an ordinary business corporation and a cooperative association, is that of Clinton Co-op. Farmers El. Ass'n v. Farmers Union Grain Terminal Association, 26 N.W.2d 117, decided by the Supreme Court of Minnesota. A statute of that State forbade any person or corporation engaged in the selling of grain as a commission merchant to buy grain received on consignment. This statute, of course, was based on the assumption that one engaged in the commission business should not act both for himself and for the consignor of grain. Obviously a conflict of interest is involved where a commission merchant attempts to buy grain consigned to him for sale.

Later, a cooperative act was enacted by the State of Minnesota authorizing the organization of farmers' cooperative associations. This statute, among other things, provided that any such association "shall have the power either as agent or otherwise to buy, sell or deal in its own products, the

products of its individual members or patrons, the products of any other co-operative association or of its members or patrons".

The Farmers Union Grain Terminal Association found that it was in the interests of its members in some cases to buy grain consigned to it for sale, and the case under discussion was brought for the purpose of determining if the cooperative was legally entitled to buy grain thus consigned to it for sale. The court held that even if the earlier statute which forbade a commission merchant from buying grain consigned to him for sale applied to the cooperative association, that this statute, at least insofar as it applied to a cooperative, had been repealed or modified. The court, however, recognized the fundamental difference between an ordinary business corporation and a cooperative marketing association, and in this connection said:

> "Defendant is buying 'the products of its individual members or patrons.' The words 'either as agent or otherwise' are, it seems to us, all-inclusive and cover the capacity of defendant to buy in any manner it sees fit. If we were to adopt plaintiff's construction of the statute, we should be required to read the word 'otherwise' out of it. There is nothing in the statute to indicate that the legislature intended that the word 'otherwise' should be ignored or given any other meaning than the usual one. To us the language is perfectly plain. It is not ambiguous and calls for no interpretation. It is our duty to give to the language chosen its plain meaning.
>
> "'Construction lies wholly in the domain of ambiguity. If the language of a statute is plain and unambiguous, there is no room for construction. A statute is to be enforced literally as it reads, if its language embodies a definite meaning which involves no absurdity or contradiction.' 6 Dunnell, Dig. & Supp. §8938, and cases cited.
>
> "Chapter 223 clearly authorizes the formation of cooperative associations to engage in the commission business and gives to such associations the power 'either as agent or otherwise' to buy the products of its individual members or patrons. So, even assuming that prior to the enactment of c. 326 the prohibitions found in L. 1917, c.19, applied to defendant, the later statute repealed by implication its applicability to defendant and its transactions. In view of our impression of c. 326, it does not seem necessary to consider, except in passing, whether L. 1917, c. 19, originally applied to defendant or other similar cooperative associations. If c. 19 originally applied to defendant, then it is repealed. If it did not apply, then, of course, defendant did not violate it. Defendant is engaged in the business of marketing grain for its members and patrons on a cooperative, nonprofit basis. All of its so-called savings belong to and are distributed to its members and patrons on a patronage basis, without discrimination between members and nonmembers. It makes no profits of it(s) own. The patrons are entitled to receive all the financial benefits of

defendant's activities. In handling the grain of its patrons, defendant is in reality a selling agency. In ordinary business transactions, the buyer, if he resells, is entitled to all the profits of the deal. The seller has received all he is entitled to. If a cooperative is a so-called buyer of the agricultural products of its patrons, the profits made in the resale inure to the seller, not to the association. The buyer and seller in this kind of a transaction occupy a different status from that of the ordinary buyer and seller. The association is in reality merely a selling agency."

As pointed out by the court in the foregoing quotation, the reason for forbidding an ordinary commission merchant from buying grain consigned to him for sale had no application to a cooperative marketing association buying grain consigned to it for sale, because in the latter case all of the gains effected accrue to the patrons on a patronage basis. In the case of the cooperative the grain was purchased by the cooperative to make more money for the patrons than would otherwise be possible. Because of the nature of the cooperative the reason for the statute forbidding a commission merchant to buy grain consigned to him for sale had no application. The reason for the rule ceasing, the rule should cease.

Voluntray "Patronage Refunds" Not Deductible

In the case of Druggists' Supply Corporation v. Commissioner of Internal Revenue, 8 T.C. ____, the principal question for decision was whether $182,249.58 which the Corporation had distributed as patronage refunds could be deducted or excluded by that Corporation in computing its income taxes for the year 1940. The Tax Court stated that:

"This proceeding involves deficiencies in income tax of $38,359.11, declared value excess-profits tax of $22,404.96, excess-profits tax of $34,270.24, and penalty for failure to file an excess-profits tax return for the year 1940 of $8,567.56."

The Druggists' Supply Corporation was organized by 100 wholesale druggists each of whom owned 10 shares of its capital stock. This Corporation entered into contracts with manufacturers under which the Corporation agreed to perform certain services of a character which in general were assumed to be calculated to increase the sales of the goods of the manufacturers.

The $182,249.58 which the Corporation distributed as patronage refunds was money which the Corporation received from manufacturers, each of whom entered into a contract with the Corporation which contained a paragraph reading as follows:

"The MANUFACTURER promises and agrees to contract for the aforesaid services of D.S.C. for the period of one year from the date hereof and thereafter shall be continued and automatically renewed for like periods, and to pay for such services by the 15th of every April, July, October and January from the date hereof, an amount

equal to _____ per centum of the net purchases by the member wholesalers of D.S.C. of the products of the MANUFACTURER during such previous period, such percentage being arrived at merely for the purpose of evaluating in dollars and cents the amount to be paid to D.S.C. for such services."

As provided in the foregoing contract provision, the Corporation, for the services which it rendered to a manufacturer, received an amount from the manufacturer equal to a prescribed percentage of the net purchases of the products of the manufacturer during a prescribed period made by the various wholesalers that were members of the Corporation. The services which were performed by the Druggists' Supply Corporation were performed by the various wholesalers that were members of that Corporation in pursuance of a contract entered into by the Corporation with each wholesaler. Each of these contracts contained a provision reading as follows:

"D.S.C. agrees to pay to the MEMBER for the aforesaid services, as soon after the close of each calendar year's business as may be, after the payment of all expenses of the operation of D.S.C. and the replenishing of any impairment of its capital and after the deduction from its receipts of such an amount for addition to its surplus account as its Board of Directors may determine, the balance then remaining from its operations in proportion to the purchases or sales from, to or through, D.S.C. and its MANUFACTURERS, by said MEMBER for each calendar year as closed; not as a dividend upon the shares of stock of D.S.C. owned by said MEMBER (which right to the payment of a dividend, if any, upon said shares of stock is hereby waived) but as a 'participation distribution'. This agreement may be cancelled at any time by reciprocal consent of the respective parties hereto." (Underscoring added.)

One of the bylaws of the Druggists' Supply Corporation read in part as follows:

"SECTION 3. Dividends. The directors may declare dividends not exceeding six percentum per annum in any one year, from the surplus or net profits arising from the business of the corporation as an [sic] when they deem expedient. Before declaring any dividend there may be reserved out of the accumulated profits such sum or sums as the directors from time to time in their discretion think proper for working capital or as a reserve fund to meet contingencies, or for equalizing dividends, or for any such other purposes as the directors shall think conducive to the interests of the company. * * * "

In denying the Corporation the right to deduct or exclude the $182,249.58 in computing its income taxes, the court said in part:

"* * * The wholesale druggist is under no obligation to the manufacturer. Purchases are not compulsory. If no purchases are made no benefit is received. Under the Membership Agreement, the whole-

saler agrees to 'assist' petitioner 'in every legitimate manner possible in the performance of the services contracted for, all in keeping with the spirit and intent of such organization'. Just what that embraces by way of a legal obligation on the part of the member is difficult to surmise. This indefinite and general provision makes it doubtful whether the 'Membership' contract serves a purpose other than as a vehicle for the wholesaler waiving his rights to dividends on his shares of the capital stock in the petitioner, and in lieu thereof to receive these so-called 'participation distributions'. We perceive in the membership contract no enforceable legal liability on the part of petitioner to make any definite and specific payments so as to entitle it to a deduction of the amounts distributed as ordinary and necessary expenses of the business. The circuitous method adopted for distributing what is in fact taxable income of the petitioner does not permit it to escape its Federal tax liability.

"We think it clear from this record that petitioner was functioning as a business corporation and not as a mere collection agency operating as a co-operative corporation. Our conclusion is based on the particular facts here presented. It will serve no useful purpose to review other authorities. We sustain the respondent's action in adding to petitioner's income, for the taxable year involved, the sum of $182,249.58." (Underscoring added.)

Particular attention is called to the underscored words in the foregoing quotation, in which the court held that the Corporation was under no enforceable legal liability to make any specific payments to any of the wholesale druggists that were members thereof. In this regard attention is directed to the fact that in the paragraph quoted above from the agreement entered into by the Corporation with each of its members, the Corporation was entitled to carry to its surplus account such an amount "as its Board of Directors may determine". Obviously, under a provision of this character all excess amounts over operating and maintenance costs and expenses could have been carried to surplus. It was only "the balance then remaining from its operations" that was to be distributed to the wholesalers who had made purchases of the goods of any of the manufacturers with whom the Corporation had contracts. And of course, as pointed out above, it lay within the power of the board of directors of the Corporation to prevent there being any balance for distribution among the wholesalers.

It is believed it is only when a taxpayer is under a fixed and mandatory obligation to pay either a definite amount or an amount which is to be determined in accordance with a rule or formula which could be applied by any competent person in possession of the basic facts, that a taxpayer will be permitted to deduct or exclude amounts arising under conditions analogous to those under discussion. If a board of directors has discretion to determine the amount that will be carried to surplus or carried to reserves, and amounts are to be distributed only after this has been done, then it is clear that the taxpayer is not under a legal obligation to account. Attention is also called to the fact that in the instant case no effort was made and no machinery provided by the organization papers for giving each

wholesaler concerned an interest in the amounts that were carried to surplus.

In the case of United Cooperatives, Inc. v. Commissioner, 4 T. C. 93 (see Summary No. 24, page 1), the Cooperative was under obligation to issue stock to patrons for amounts that were retained in the business, and the amounts for which it was under obligation to issue stock were held to be deductible or excludable in computing the income taxes of this nonexempt Cooperative. A similar conclusion was reached in the case of Appeal of Paducah & Illinois Railroad Company, 2 B.T.A. 1001 (see Summary No. 30, page 1).

In the opinion in the case of American Box Shook Export Association v. Commissioner, 156 F.2d 629, the court said (see Summary No. 31, page 7):

> "In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its bylaws, or some other contract."

In the instant case the Tax Court refused to permit the Commissioner of Internal Revenue to impose a penalty on the Druggists' Supply Corporation for failure to file an excess profits tax return for the taxable year 1940. The reasons for refusing to permit the imposition of a penalty are disclosed in the following quotation from the opinion:

> "There remains for consideration the propriety of respondent's action in assessing a penalty of $8,567.56 for failure to file an excess-profits tax return for the taxable year 1940. It is conceded that no such return was filed. By section 291 of the Internal Revenue Code the penalty is to be imposed 'unless it is shown that such failure is due to reasonable cause and not due to willful neglect.' For 30 years petitioner has been filing its Federal income tax returns showing no income and these service fees credited to members as a liability for accounts payable. On at least two previous occasions the revenue agents have inquired of the petitioner about such treatment of these service fees. Upon being informed of the facts, these agents referred the question of the proper treatment of these fees to higher authority. Later, the revenue agents advised petitioner that its treatment was approved. Relying on this approval petitioner filed no excess-profits tax return for 1940 because such treatment resulted in no taxable income. We think such facts are even more favorable to the taxpayer than those revealed in Hugh Smith, Inc., 8 T.C. 660, in which we struck the penalty. Under such circumstances we hold that the failure to file such return was based upon a reasonable belief that it was not required and that the imposition of the penalty is not justified." (Underscoring added.)

Members Acting As Dealers

There follows a complete copy of a ruling of the Bureau of Internal Revenue as it appears in Internal Revenue Bulletin No. 12 issued June 16, 1947:

"Section 29.101(12)-1: Farmers' cooperative marketing and purchasing associations. 1947-12-12563
I. T. 3853

Internal Revenue Code and Revenue Acts of 1936 and 1938.

Where a cooperative marketing association markets products purchased by members in an amount the value of which exceeds the value of products grown or otherwise produced by members for whose accounts such products are marketed, the limitation placed on business done for 'nonmembers,' contained in section 101(12) of the Internal Revenue Code and corresponding provisions of prior revenue laws, is violated. Furthermore, in marketing and otherwise handling the products of nonmembers as those of its members, such an association does not meet the statutory requirement that the proceeds of the sale of products, less necessary operating expenses, be returned to producers on the basis of the quantity or value of products furnished by them, and the association is not exempt from Federal income tax under section 101(12) of the Code and corresponding provisions of prior revenue laws.

"Advice is requested whether a cooperative marketing association which otherwise qualifies for exemption from Federal income tax under section 101(12) of the Internal Revenue Code and corresponding provisions of prior revenue laws will be denied exemption if it markets products purchased by the members in an amount the value of which exceeds the value of the products grown or otherwise produced by the members for whose accounts the purchased products are marketed.

"In the instant case the association is engaged in packing and shipping fruit supplied by members, a substantial amount of which is not produced by them but is purchased on the open market. Net profits from operations are allocated to members on the basis of the value of products furnished by them. During each of the years involved the value of the amount of fruit purchased by members of the association and handled by it was in excess of the value of the amount of fruit grown or otherwise produced by them.

"Section 101(12) of the Internal Revenue Code and the corresponding provisions of the Revenue Acts of 1936 and 1938 provide for exemption of the following organizations:

> (12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them. * * * Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members * * *

"With respect to the marketing of products purchased by members, as distinguished from products produced by members, in Northwestern Drug Co. v. Commissioner (14 B.T.A., 222), the Board of Tax Appeals, now The Tax Court of the United States, in construing section 231 (11) of the Revenue Act of 1921 (corresponding to section 101(12) of the Code) said:

> * * * The plain intention of Congress was to grant certain benefits to groups of producers organized to sell their own crops or other products through cooperative sales agencies, or to purchase supplies and equipment for the use of members in their activities as producers. [Italics supplied.]

"That decision was followed in Sunset Scavenger Co., Inc. v. Commissioner (31 B.T.A., 758, affirmed on appeal on this issue, 84 Fed. (2d), 453, Ct. D. 1190, C. B. 1937-1, 202) which involved section 231(12) of the Revenue Act of 1926 and section 103(12) of the Revenue Act of 1928 (both of which correspond to section 101(12) of the Code). In its opinion, the Board stated:

> Despite the very extensive argument of petitioner's counsel on brief to convince us that waste paper, junk, garbage in place, and labor constitute 'products' of the stockholders or members of petitioner, which are merely 'marketed' by the latter, we can not agree with his contention that petitioner is similar in all essential respects to a cooperative agricultural marketing association which sells for its members the fruits or vegetables produced by them and delivered to it for sale, remitting to them the proceeds less the cost of selling. [Italics supplied.]

"Bearing in mind the intent of section 101(12) of the Code, supra, as above expressed, the term 'products' as used therein must be deemed to have reference to products grown or otherwise produced by the patron for whose account such products are marketed. Products grown by one who is not a member of the cooperative marketing association must be treated as 'products of nonmembers,' notwithstanding such products are marketed by the association in the name of, or for the account of, a member.

"In view of the foregoing, it is held that where a cooperative marketing association markets products purchased by members the value of which exceeds the value of products grown or otherwise produced by members for whose accounts such products are marketed, the limitation placed on business done for 'nonmembers,' contained in section 101(12) of the Internal Revenue Code and corresponding provisions of prior revenue laws, is violated. Furthermore, in marketing and otherwise handling the products of nonmembers as those of its members, such an association does not meet the statutory requirement that the proceeds of the sale of products, less necessary operating expenses, be returned to producers on the basis of the quantity or value of products furnished by them, and the association is not exempt from Federal income tax under section 101(12) of the Code and corresponding provisions of prior revenue laws."

The foregoing ruling involved situations in which the members of certain cooperative associations engaged in the buying of commodities, which they delivered to their cooperative associations along with agricultural commodities produced by themselves. In this ruling the Bureau specifically holds that commodities so purchased by members of an association must be considered as nonmember business. In view of this ruling, an association could be held to be ineligible for exemption because it handled more products for nonmembers than it handled for members, although the association itself purchased no commodities from nonmembers.

The Bureau of Internal Revenue not only held that the associations involved lost their exemption because of the amount of agricultural commodities that had been purchased by their members and delivered to the associations, but the Bureau also in the foregoing ruling holds that the requirements of the statute with respect to exemption are not met under these conditions because nonmembers are not dealt with on the same basis as members. Obviously, where the savings effected on products purchased by members from nonmembers are returned only to the members and retained by them, the so-called nonmembers are not dealt with on the same basis as the members. It will be recalled that in order for an agricultural cooperative association to be eligible for exemption from the payment of Federal income taxes, nonmembers must be treated the same as members, and this of course means with respect to prices paid, patronage refunds, and interest in reserves.

Although it is not specifically discussed in the foregoing ruling, any association which desires to be eligible for exemption should not handle commodities for dealers. In other words, an association, if it desires to be eligible for exemption, should market commodities only for its own producer-members or for "other producers". This operates to bar an association, insofar as exemption is concerned, from acquiring commodities from persons other than producers, and as held in the ruling under discussion, the producers from whom agricultural commodities are acquired should actually produce those commodities.

Attention is called to the fact that while the Capper-Volstead Act, which authorizes farmers to form cooperative associations, permits such associations to do as much business with nonmembers as they do with members, the legislative history of the Capper-Volstead Act makes it clear that Congress intended that the members of an association which desires to be eligible for the benefits of this Act must produce at least one-half of the agricultural commodities handled or marketed by the association. Numerous statements made by the Committee on the Judiciary of the Senate which had charge of the bill lead to this conclusion. For instance, that Committee said:

> "But the protection of the statute ought not to be given to a small number of persons of the classes named in the bill who contribute from their own farms an inconsiderable quantity of the product handled by the association." (Congressional Record, 67th Cong., 2d Sess., p. 2121.)

Although the foregoing ruling is silent on the point, it is believed the Bureau proceeded on the theory that the officers and directors of the cooperative associations involved were aware of the fact that their members were engaged in the purchase of agricultural commodities. It is difficult to believe that if a cooperative association had no knowledge that its members were buying agricultural commodities and no reason to believe that they were doing so, that the same conclusion would be reached. If an association had bylaws prohibiting members' buying commodities and delivering them to the association, this would strengthen its position.

Dividends Taxable Despite Contract

In Soreng v. Commissioner of Internal Revenue, 158 F.2d 340, it appeared that Edgar M. Soreng and his wife, Mary Soreng, owned a substantial part of the common stock of the Soreng-Manegold Company. They were apparently desirous of owning all of the outstanding common stock of the corporation. The Soreng-Manegold Company obtained options on all of the issued common stock other than that owned by Mr. and Mrs. Soreng.

> "The financial condition of the corporation was such that it was unable to exercise its right to purchase under the options. In order to obtain the necessary funds it decided to and did sell its accounts receivable to Walter E. Heller & Company for the sum of $31,016.70, and at the same time borrowed from the same company the sum of $15,000."

On January 26, 1940, the Soreng-Manegold Company purchased the common stock of the Company on which it had options and on the same date it made dividend payments to Mr. Soreng in the amount of $8,804.75, and to his wife in the amount of $3,557.75.

Before Walter E. Heller & Company would make the loan to the Soreng-Manegold Company it entered into a contract with Mr. and Mrs. Soreng under which they were obligated to pay the full amount of the dividends

received by them to the Soreng-Manegold Company, and Mr. and Mrs. Soreng on receipt of their dividend checks promptly paid like amounts to the Company in fulfillment of their contract.

The sole question for decision was whether the dividends received by Mr. and Mrs. Soreng constituted taxable income from the standpoint of income taxes. In holding that such dividends constituted taxable dividends the court said:

> "Undoubtedly, the distribution thus made to the petitioners falls squarely within the definition of a 'dividend' under Sec. 115 (a) of the Internal Revenue Code, supra. The petitioners do not seriously argue otherwise, but they contend that the distributions did not constitute taxable dividends for the reason that the distributions so received were immediately paid by them to the corporation pursuant to the agreement previously entered into with Walter E. Heller & Company. This contention is predicated upon a provision contained in Treasury Regulation 111 (Sec. 29.115-1) as follows:
>
> "'A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.'
>
> "The argument is that the dividends received by the petitioners were not 'unqualifiedly made subject to their demands' because of their contractual obligation to return the same to the corporation. Both sides concede that there is no case directly in point. The petitioners cite a number of cases which they argue by analogy support their view. The case most relied upon is that of Avery v. Commissioner of Internal Revenue, 292 U.S. 210, 54 S.Ct. 674, 78 L.Ed. 1216. In that case, however, the issue was as to the time the dividends had been received by the taxpayer, and, therefore, the year in which they were to be included in the taxpayer's gross income. No question was raised but that the dividends were taxable either in one year or the other, depending on the year in which they were received. Here there is no question as to the fact or time of receipt. The sole question is whether they were immune from taxation because the petitioners were under a contractual obligation to deliver them to the corporation.
>
> "Another case which the petitioners assert to be analogous is that of Jackson v. Commissioner of Internal Revenue, 3 Cir., 51 F.2d 650. A reading of that opinion discloses that it furnishers no support for the taxpayer's contention. True, in that case the shareholders returned to the corporation dividend checks. The question for decision, however, was whether the dividends received by the stockholders were stock or cash dividends. The court held that they were the former. Other cases cited by the petitioners are likewise of no assistance.

"We think the decision of the Tax Court is correct. We can discern no rational basis for a holding that the dividends received by the petitioners are not includable in gross income merely because they of their own accord entered into a contract with a third party as to the manner of their disposition when received. Suppose the petitioners had entered into an agreement with some other party, for instance a bank, obligating themselves to turn over the dividends upon receipt. Could it be seriously contended that by reason of such contract the dividends were not 'unqualifiedly made subject to their demands?' We discern no difference in principle between this hypothetical situation and the instant one.

"More than that, the petitioners, by obligating themselves to pay these dividends to the corporation, aided in the accomplishment of a program by which they became the sole owners of the corporation's common stock. It therefore cannot be argued that they received no benefit from the transaction. In fact, it may well be that they made a desirable and profitable investment of the dividends which they had received." (Underscoring added.)

The decision of the court, which affirmed the holding of the Tax Court, seems entirely correct. Dividends do not cease to be taxable dividends because of the disposition that a taxpayer may elect to make of them. By contracting how dividends will be spent or used on their receipt does not operate to cause such dividends to cease to be income in the hands of the recipient.

Employee or Independent Contractor

In the case of Green Valley Cooperative Dairy Co. v. Industrial Commission, (Wis.), 27 N.W. 2d 454, a case which arose under the Workmen's Compensation Act of Wisconsin, the liability of the association for injuries sustained by an alleged employee depended squarely upon the question of whether the person was an employee of the association or an independent contractor.

In general, an independent contractor is employed to do a job and is responsible only for results, and is not subject to control by the person for whom the work is being done, except possibly in broad outline. In the instant case the court found that the cooperative at least had the authority to exercise control over the activities of the employee and hence that the association was liable. The following quotation from the opinion shows the basis therefor:

"Likewise the fact that for Karlen's services for Dairy his compensation was at the rate of specified sums per hundred weight dependent upon the quality and quantity of the cheese produced, and was subject to his paying the assisting workers for their services, does not necessarily render his status that of an independent contractor instead of an employee of Dairy. The arrangement as to Dairy's

payments for his services was merely its method of fixing his compensation therefor as was done in Tiffany v. Industrial Comm., supra. Although Karlen, in connection with his work in making cheese for Dairy, also served as virtually its manager in the conduct of its operations in the production thereof until it was stored prior to sale by Dairy, without participation therein of Karlen, his activities were apparently and presumably subject to the right of control by Dairy and its officers at all times. So, due consideration of the entire arrangement between the parties warrants the inference that although Dairy did not exercise its right to control the details of the production of cheese, it did have that fundamental right, and if it had seen fit to exercise such control, Karlen had a choice of either obeying and complying therewith, or of resigning or being discharged by Dairy. When an employer has such right of summary discharge, he obviously has the right to control details of the work. Karlen's remuneration was not determined by the selling price of the cheese, and he did not share in Dairy's profit from its business operations."